UNITED STATES BANKRUPTCY COURT

SOUTHERN DISTRICT OF NEW YORK

Main Case No. 09-10497, Adv. Case Nos. 10-03339

- -x

In the Matter of:

FORTUNOFF HOLDINGS, LLC AND FARRISILK, INC.,

Debtors.

- -x

In the Matter of:

GAZES et al.,

Plaintiffs,

v.

NEW YORK STATE DEPARTMENT OF LABOR.

Defendant.

- -x

U.S. Bankruptcy Court

300 Quarropas Street

White Plains, New York

January 24, 2011

2:33 PM

B E F O R E:

HON. ROBERT D. DRAIN

U.S. BANKRUPTCY JUDGE

HEARING re: Judge's Bench Ruling on Motion for Preliminary Injunction

Transcribed by: Sara Davis

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P R O C E E D I N G S

THE COURT: Good afternoon. This is Judge Drain in In re Fortunoff Holdings and Gazes v. New York State Department of Labor. Do I have counsel for the DOL and the trustee on the phone?

MS. KAKALEC: Yes, Your Honor. Patricia Kakalec from New York State Attorney General's Office for the DOL.

THE COURT: Okay.

MR. JARUSHEWSKY: And Jayson Jarushewsky from Gazes LLC for Ian G. Gazes, the Chapter 7 Trustee.

THE COURT: Okay. And do I also have counsel for the putative class action claimants?

MS. ROUPINIAN: Yes, Your Honor. Rene Roupinian on behalf of Iannacone et al.

THE COURT: Okay. I understand from a call placed by my chambers to the parties that there have not been further settlement discussions in connection with the New York State WARN Act claims and that it's highly unlikely that there will be until the issue raised by the trustee's request for a preliminary injunction is dealt with. Is that correct as far as the parties are concerned?

MR. JARUSHEWSKY: Yes, Your Honor.

THE COURT: Okay. And who is that?

MR. JARUSHEWSKY: I'm sorry, this is Jayson Jarushewsky.

THE COURT: Okay.

MS. KAKALEC: Your Honor, this is Patricia Kakalec from the AG's office. I believe that's the case, although the attorney who's primarily has been handling this had a conflict with the time change and so I'm not the attorney in the office who's most familiar with it. But I am familiar with the case and my understanding is that that's true.

THE COURT: Okay. And that's fine. I had expressed the hope that this could all be resolved on a global basis, not only at the hearing but I guess thereafter. But I understand the parties' issues and concerns and I'm not prepared to delay this ruling further in light of the --

The matter before me is a motion by the Chapter 7 trustee in this case for either a declaration that the automatic stay applies to an administrative proceeding commenced by the New York State Department of Labor or DOL or, in the alternative, to preliminarily enjoin that proceeding under Section 105(a) of the Bankruptcy Code. The proceeding at issue is to enforce, to the extent applicable, the New York State's Worker Adjustment and Retraining Notification Act, or the New York WARN Act, W-A-R-N Act, New York Labor Law Section 863, 60-i. It was commenced to determine whether pay or back -- I'm sorry, back pay is owed to certain employees of the debtor as a result of the termination of their employment, starting shortly after the February 6th, 2009 Chapter 11 filing

by the debtor, Fortunoff, and the ultimate sale of its business and the closing down of various Fortunoff stores later that summer.

The Court established a bar date for filing claims in this case of June 5, 2009 and the New York DOL filed claims under the New York WARN Act. In addition, certain individual employees or former employees of Fortunoff filed claims that included both New York and federal WARN Act claims. And finally, in addition, a putative class of former Fortunoff employees filed timely class claim -- or claim before the bar date on behalf of that putative class asserting both federal and New York WARN Act claims. The case was converted to Chapter 7 in light of the sale of the debtor's business and the Court's determination that the debtor and its creditors and other parties in interest were better served by conversion of the case to Chapter 7. And the Chapter 7 trustee, I believe all agree, has been diligently determining the potential amount of WARN Act claims, both under the New York State Warn Act and the federal WARN Act and also liquidating the remaining assets of the debtor's estate or the debtor's estates which consist of litigation claims.

The trustee has opposed class certification for the WARN Act putative class, but that issue has not yet been determined by the Court. The trustee has also expressed his desire to resolve the WARN Act claims as a group, that is both

the individual claims, the class claim and the New York State claim; the former two groups of claims comprising, again, both federal and New York WARN Act claims. But they have not been resolved consensually. Negotiation of the WARN Act claims would entail more than simply determining the upper most amount of those claims and the factual issues surrounding them, but it would also entail a resolution of the legal issues pertaining to those claims, including whether various exceptions to the federal and New York State WARN Act liability would apply.

The New York State WARN Act is a fairly recent statute; it was enacted in 2008 and there is little case law construing it and, as far as I could determine, no Bankruptcy Court case law dealing with it at this point. Unlike the federal WARN Act, it provides not only for a private right of action to enforce a valid New York State WARN Act claim but also provides that the commissioner of the DOL has the right to enforce the Act on behalf of the state. Both enforcement methods may be followed in a single case, that is civil, individual or class action enforcement as well as enforcement by the DOL. See Section 860-g(4) which provides that in an administrative proceeding by the commissioner, any liability paid by the employer prior to the commissioner's determination as the result of a private action brought under this article and in a private action brought under this article, any liability aid by the employer in an administrative proceeding

by the commissioner, prior to the adjudication of such private action, will reduce the liability in the other action.

It's clearly the case that, consistent with the foregoing section of the statute, that the ultimate beneficiaries of any monetary judgment under the New York WARN Act would be the covered employees. That is, whether they bring the action themselves or whether the action is brought by the New York Commissioner of the DOL. The first issue before the Court is whether the DOL administrative proceeding which was commenced in November of 2009 after the filing of the proofs of claim in this court and after the trustee had objected to the class claim and was pursuing the resolution of all of the claims, whether that proceeding commenced by the DOL is subject to the automatic stay under Section 362(a)(4) -- I'm sorry, under 362(a) of the Bankruptcy Code or is, instead, subject to the exception to the automatic stay found in Section 362(b)(4) of the Code.

That exception provides, in relevant part, that the automatic stay under paragraph 1, 2, 3 or 6 of Subsection (a) of Section 362 of the commencement or continuation of an action or a proceeding by a governmental unit to enforce such governmental unit's police and regulatory power including the enforcement of a judgment other than a money judgment obtained in an action or proceeding by the governmental unit to enforce such governmental unit's police or regulatory power is not

subject to the automatic stay.

The DOL contends that the DOL administrative proceeding falls within the exception, recognizing, as it must, that if it in fact does fall within the exception, once the amount of the claim is liquidated, any action to enforce the claim against the debtor or its property or to determine the priority of such liquidated claim or the applicability of the ruling to third parties including, most particularly, to the class action claimants, would be subject to the automatic stay and further determination by this Court. See SEC v. Brennan 230 F.3d 65 (2nd Cir. 2000) as well as 3 Collier on Bankruptcy, paragraph 362.05[5][b] at page 362-65, 16th Edition 2010.

The trustee contends, on the other hand, that the DOL action is subject to the automatic stay and that it does not fall within the exception under Section 362(b)(4) and further, that this is not the type of situation under the Second Circuit's criteria set forth in In re Sonax 907 F.2d 1280 (2nd Cir. 1990) under which the Court would lift the automatic stay to permit non-Bankruptcy Court litigation to proceed.

The courts are in general agreement that Section 362(b)(4) is to be applied to a particular governmental action by looking at the nature of the action and the other underlying statute that it seeks to vindicate. The Court does not have the jurisdiction to determine the validity under the nonbankruptcy statute of the governmental body's action, in

this case, the validity of the DOL's bringing the administrative proceeding but rather is limited to determining whether that proceeding falls within the criteria set forth in 362(b)(4). See Board of Governors v. MCorp Financial, Inc., 502 U.S. 32, 40 through 41 (1991).

The courts have developed two tests to evaluate whether the government's action falls within Section 362(b)(4), although there is some dispute among the courts, including in this circuit, whether the first test is narrow or not. The first test is whether the governmental unit is pursuing a pecuniary interest rather than a matter of public safety or welfare. If it is the latter, then it would fall within the exception. If it is the former, it would not. The second test is the so-called public policy test. That is, is the government action designed to effectuate public policy rather than to adjudicate private rights. If it the former, then the exception applies. If it the latter, that is the adjudication of private rights, it does not.

The controversy within courts in this jurisdiction is whether the pecuniary interest test is properly seen as a narrow test, wherein the government is asserting effectively its own or third parties' pecuniary interest. Or whether it should be determined on a broader basis, that is broadening the basis for the exception under 362(b)(4) and permitting the exception to apply as long as the government is not looking to

derive a pecuniary advantage placing it or its intended beneficiaries at an advantage as against what would otherwise be similarly situated creditors.

The former, narrow construction basically focuses on whether the primary purpose of the government's action is to obtain money for the government or third parties. The latter focuses on whether, essentially, the government's action either in obtaining money or preventing the debtor from taking a certain action would grant a priority to or prefer what would otherwise be similarly situated parties. Compare United States ex rel. Fullington v. Parkway Hospital, Inc. 351 BR 280 (E.D.N.Y. 2006) with In re Enron Corp. 314 BR 524 (Bankr. S.D.N.Y. 2004) and In re Chateaugay Corporation 115 BR 28 (Bankr. S.D.N.Y. 2008). See also In re Pollock, P-O-L-L-O-C-K, Jr. Stone Artist, Inc. 402 BR 534 (Bankr. N.D.N.Y. 2009) in which Judge Littlefield noticed or noted the distinction but found ultimately that under either test, the regulatory action proposed would be exempt or excepted from the automatic stay under Section 362(d)(4).

The trustee and the class action claimants who have joined in support of the trustee's preliminary injunction motion contend that the exception would not apply here and that the government, through the DOL, is essentially vindicating their private rights. They point out that as Judge Gonzalez did in the Enron Corporation that I've cited, as well as Judge

Lifland in the Chateaugay Corporation that I've cited, the debtor is out of business and will never resume business as Fortunoff. And consequently, the only immediate effect of the DOL administrative proceeding is to fix the amount of the DOL's claim on behalf of the former employees and for their ultimate benefit and, therefore, that the claim liquidation proceeding is one that has only a pecuniary purpose. Albeit, not for the government, but for the ultimate beneficiaries, the employees.

On the other hand, the DOL asserts that particularly in the area of labor law, the courts have long recognized that the ability of a governmental entity to seek and obtain a money judgment is one that serves public policy and has an effective deterrent effect on future conduct. Even where, as is the case here, the debtor itself will no longer be conducting business. See, for example, the discussion by former Judge Garrity in In re Ngan Gung Restaurant, Inc., that's spelled N-G-A-N G-U-N-G Restaurant, Inc., 183 BR 639 (Bankr. S.D.N.Y. 1995), as well as In re Travacom Communications, Inc. 300 BR 635 (Bankr. W.D.Pa. 2003) and the Court's discussion in In re Fiber Optek, O-P-T-E-K, Interconnect Corp. 2009 WL 3074605 (Bankr. S.D.N.Y. Sept 23, 2009) of the widely recognized applicability of Section 362(d)(4) in contexts where a state regulatory body has been asked to -- I'm sorry, is seeking to enforce monetary sanctions for the benefit of third parties against a debtor, whether that debtor is still operating or not.

I recognize that the Fiber Optek discussion is dicta, but certainly the cases that it cites and those cited in the Ngan Gung case stand for the proposition. See also NLRB v. 15th Avenue Ironworks, Inc., 964 F.2d 1136 (2nd Cir. 1992) and numerous other decisions applying the exception of 362(d)(4) in a labor law context where there is a separate right of action by individual claimants or a private right of action and monetary relief is sought.

See, generally, the case is cited at 3 Collier on Bankruptcy, paragraph 362.05[5][b][i], footnote 97 and 95. Here, the legislative history, at least, of the New York WARN Act makes clear the public policy asserted by the legislature to protect employees from precipitous termination by their employers and legislature's belief that without the enforcement power and ability of the DOL to seek monetary relief on behalf of such employees, the foregoing purpose would not completely served. In light of that and the extensive case law applying the exception of 362(b)(4) in a labor law context where money damages are sought, including as against defunct entities, I find that the 362(b)(4) exception applies to the DOL administrative proceeding.

There is clearly, it seems to me, a one-to-one correspondence as far as the actual remedy sought here which would fit the DOL proceeding into the logic of Judge Gonazalez's Enron Corporation case at 314 BR 524. However,

that case, I think, is distinguishable here on two grounds. First, in that case, unlike here, other governmental bodies were pursuing very similar actions on a wider scale against Enron for its alleged wrongdoing. Therefore, the State of California's action seeking monetary damages for its citizens for manipulation of the energy markets was viewed simply as redundant or piling on, as afar as any public policy deterrence effect, leaving the only basis, in essence, one of forum shopping for liquidating a monetary claim.

Here, while there is an attempt on behalf of a putative class to enforce a claim against the debtor against the New York WARN Act as well as attempts by individual claimants to do so, the DOL is not, I believe, piling on where other governmental agencies have already done so. Secondly, the very nature of the New York WARN Act claim, that is a claim arising upon termination based on, in this case at least and in most cases, the shutting down of a substantial workplace, can in large measure only be brought after the fact and consequently can have a deterrent effect only on future violations of the statute through a money judgment that can then be pointed to if future employers seek to do the same thing that the employer against whom the money judgment was imposed did.

In other words, it seems an entirely legitimate means to deter employers as a whole from violating the statute to

seek a money judgment against an employer that's going out of business or that has gone out of business. Consequently, it appears to me that the public policy and pecuniary interest test, whether it's pecuniary advantage or the more narrow test, would be satisfied here. And again, as the DOL recognizes, the stay would not apply only to the extent that the claim would be liquidated. It would continue to apply to enforcement and determinations as to priority.

I'll further, then, turn to the trustee's request, joined in by the class action claimants, to enjoin the prosecution of the DOL administrative proceeding, notwithstanding the congressional policy that it would be exempt from the automatic stay under Section 362(b)(4). The parties disagree over the applicable standard for evaluating the request for the entry of a preliminary injunction here. In essence, as to whether, given that the relief being sought is against a governmental agency and effectively would grant permanent relief since it would preclude the prosecution of the DOL action, the trustee needs to show a likelihood of success on the merits as well as irreparable harm.

The Court concludes that it does not need to resolve that dispute for the following reasons. First, the harm that the trustee asserts would occur here if the DOL administrative proceeding were permitted to resume and continue through the liquidation of the claim is that he would need to litigate in

that proceeding the New York WARN Act issues, which would mean that there would be piecemeal litigation, not only of those issues since the individual and class action claims under the New York WARN Act are here before the Court and will be litigated here but also, because the New York WARN Act in many important respects is analogous or in fact word-for-word the same as the federal WARN Act which issues would be dealt with by this Court.

Thus the trustee contends that he would be forced to litigate essentially the same types of issues in two different forums and secondly, that there's a distinct possibility that the determination of those issues might result in contradictory rulings. The class action claimants also contend that the litigation of the New York WARN Act issues in the DOL proceeding would take more time than is appropriate for the liquidation of these claims, this delaying any distribution to the ultimate beneficiaries. At least, if one goes not only through the DOL proceeding itself, but also up through the appellate chain in the New York State courts. It is importantly not the case that the litigation in the DOL proceeding would jeopardize the debtor's reorganization or rehabilitation, as I noted the debtor is in Chapter 7 and moreover, the trustee would not be so distracted by the state court -- I'm sorry, the DOL administrative proceeding that he could not otherwise perform his job as Chapter 7 trustee of

these estates.

Thus, I do not believe that the estates as administered by the trustee would suffer irreparable harm here if the DOL proceeding went forward. Nor do I believe that the balance of hardships would tilt decidedly in the trustee's favor. I have some serious concerns about whether, given the policy behind Section 362(b)(4), I have the power even to enjoin a governmental proceeding such as the DOL administrative proceeding. The Supreme Court in the MCorp case that I cited earlier leaves that issue open, I believe. Although noting, consistent with the SEC v. Brennan case, that enforcement issues by the plain meaning of the statute would still be subject to the stay.

Collier, on the other hand, recognizes a power to enjoin when necessary and appropriate to protect the debtor's reorganization or rehabilitation effort, a governmental proceeding that would otherwise be exempt under Section 362(b)(4). See 3 Collier on Bankruptcy, paragraph 362.05[5][d]. However -- I'm sorry, [5][b], excuse me. However, the authorities that it cites for that proposition are not by any means the most compelling on that particular point, since they're largely dicta on that point. See In re Friarton Estates Corp 65 BR 586 (Bankr. S.D.N.Y. 1986) and Saravia v. 1736 18th Street, NW Limited Partnership 844 f.2d 823 (DC Circuit 1985). Moreover, Collier states in the same paragraph,

"a mere risk of increase in legal fees and diversion of the debtor's time and resources might not be enough to get an injunction because of the congressional policy providing some protection to police or regulatory actions". CF In re Adelphia Communications Corp. 345 BR 69,78 (Bankr. S.D.N.Y. 2006) in which case Judge Gerber made a distinction between, as he did, in joining private attempt to enforce the antitrust laws that jeopardized Adelphia's reorganization and sale with a hypothetical governmental attempt to do so.

But in any event, it appears to me, given the context of this case that while, as I said before, I have strongly urged all of the parties not to proceed with litigation given the limited pie here and all of the issues involved including the overlapping issues of the federal WARN Act claims, to settle those issues, I believe that I do not have the power under these circumstances to interfere with the DOL's determination, apparently notwithstanding the wishes of the putative representatives of the DOL's own beneficiaries to liquidate the claim in the DOL proceeding and subject to all of the rights of appeal there from.

If I were to issue an injunction of a proceeding like this, this is not the right context to do it in. It would have to be in a context that, as Collier recognizes, the debtor's reorganization or rehabilitation is truly jeopardized by the governmental proceeding. Because of the trustee's inability to

show the irreparable harm/balance of harm or meet the irreparable harm/balance of harm test, I don't need to get into the merits of the underlying dispute. That is, whether the New York WARN Act claims are valid or not or are subject to various defenses.

The last point raised by the trustee at oral argument and frankly also pursued by the Court at oral argument is whether, given the timing of the commencement of the New York DOL proceeding, that is several months after the issue was joined in this court over WARN Act -- New York WARN Act claims, t he First-to-File doctrine or any similar doctrine might apply here. That would lead the Court not on traditional preliminary injunction grounds, but on a more equitable time management basis to enjoin the latter commenced DOL proceeding.

I asked the parties to brief that issue and I'm satisfied, based upon the submissions by the DOL, that the First-to-File doctrine, to the extent it would have been applicable if the DOL proceeding were not what it is but rather a proceeding that was presently in federal court somewhere in the nation, should not apply here. The issues that the First-to-File doctrine addresses, that is how to manage overlapping litigation pending in two different courts, certainly do exist here. However, given that the DOL proceeding is an administrative proceeding not in a federal court, the doctrine does not apply. That raises the possibility of inconsistent

results and inefficiencies, but I don't believe that I have the power to enjoin the DOL proceeding in light of those risks. See, generally, In re Cuyahoga Equipment Corp. 980 F.2d 110 (2nd Cir. 1992) and William Gluckin & Company v. International Playtex Corp. as well as the other authorities cited in the DOL's post-hearing submissions.

I had also raised at oral argument whether there is any practice or regulation dealing with the present set of facts which is where both the DOL and individual WARN Act claimants have asserted claims and, indeed, where a putative class has asserted claims on behalf of individuals. To sort out how those claims should be pursued as a practical matter, the responses have not provided any guidance as to whether there is any regulation or practice for sorting out how the potentially conflicting interests of individual claimants under the New York WARN Act are dealt with in light of the DOL's decision to pursue a claim on their behalf. Clearly, as the DOL did point out, there are many instances in both New York State and federal law where there is a potential for overlapping claims involving private rights of action where also regulators have rights of action. I believe that the existence of such overlapping claims, as asserted in this case, doesn't preclude the DOL from pursuing its rights, which, again, I found are not subject to the automatic stay in the administrative proceeding. And it will be incumbent upon the

entity presiding over that proceeding as well as the courts over any appeal to try to balance the interests of the individual claimants and the DOL and the potential for resolution of those matters in front of me.

There is no formal motion for abstention in this case. And I believe, particularly given that the proofs of claim filed by the individual claimants of the class are not limited to New York WARN Act claims, that I should proceed on whatever appropriate schedule to determine those claims. In addition, the Code provides for the estimation of claims and the liquidation of claims in a prompt and practical way and, of course, furthers settlement. So it's conceivable to me certainly that the beneficiaries of the DOL claim may have their claims not only determined but also settled in front of me, at which point I'll have to determine how the crediting mechanism really should work under the section of the New York WARN Act that I previously quoted. But in the meantime, because I'm going to deny the trustee's request for injunctive relief and to enforce the automatic stay, the DOL will be free to proceed to liquidate its claims in the administrative proceeding.

So, ma'am, could you have Mr. Kupferberg submit an order consistent with my ruling by e-mail to chambers?

MS. KAKALEC: Yes, Your Honor, I will do that.

THE COURT: Okay. Thank you. You don't have to

settle that order but, obviously, you should copy the trustee and his counsel and class counsel when you send it in. And, in fact, it's probably a good idea to run it by them beforehand --

MS. KAKALEC: I'll do that.

THE COURT: -- so they're sure it's consistent with my ruling.

MS. KAKALEC: Yes, Your Honor.

THE COURT: I apologize. I had sort of let this slip for a few weeks after I was informed that it was unlikely that there would be a settlement absent a ruling by me. Not that there would be a settlement because of a ruling by me, either. So I've given you my ruling orally as I often do when I give a long bench ruling, I'll get the transcript after one of you or I'll order it. I'll review it carefully not only for typos and mis-citations, but also to make changes if I think I left out something that I should have said or put in something that was inaccurate or, frankly, even to improve my grammar. But the substance of the ruling won't change, which is that the motion for injunctive relief is denied and consequently, there's really no purpose served in pursuing the complaint. Although, obviously, all of the trustee's defenses to the underlying claim, whether it's litigated here or in the DOL administrative proceeding, are fully preserved as well as, of course, any responses to them.

Any questions?

MS. KAKALEC: No, Your Honor.

THE COURT: Okay. All right, thank you very much.

IN UNISON: Thank you, Your Honor.

THE COURT: Okay.

MS. KAKALEC: Goodbye.

(Whereupon these proceedings were concluded at 3:38 PM)

I N D E X

RULINGS

C E R T I F I C A T I O N

I, Sara Davis, certify that the foregoing transcript is a true and accurate record of the proceedings.

Sara Davis

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